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Taxation of Foreign-Earned Income In Kind: Henry Taxpayer goes to Japan

Two problems which plague United States tax law are whether to tax foreign-earned income of Americans living abroad, and how to tax income provided in kind. The former issue raises questions of trade policies and tax purposes, usually secondary in tax law decisions, while the latter involves problems of equal treatment and the tax base, typically the principal concerns of United States income taxation. These were the questions before Congress when it recently enacted section 913 of the Internal Revenue Code, which was designed to solve the problem of taxing foreign-earned income in kind. The two issues meet in the Japanese housing case.¹

Henry Taxpayer is employed by Gulf Oil Company as an executive officer. He is married and has two dependent children, aged six and nine.² Last year, Henry was invited to become the vice-president of Gulf's Tokyo office. Although initially hesitant,³ he decided to accept Gulf's offer of temporary transfer,⁴ and moved with his family to Tokyo. In Japan, Henry received \$50,000, the same annual salary he had earned in the United States. In addition, Gulf reimbursed him \$200 for expenses incurred in sending his children to a "United States-type" school, and provided him and his family with a Western-style apartment.⁵ Gulf paid the market price of \$20,000 per year for the apartment.

This note will consider whether the market value of the apartment pro-

¹The facts of this Japanese housing example are those of *Adams v. United States*, 214 Ct. Cl. ___, 77-2 U.S.T.C. ¶9613 (CCH) (1977); *McDonald v. Comm'r*, 66 T.C. 223, CCH Dec. No. 33, 806 (1976); *Stephens v. Comm'r*, 35 T.C.M. 39 (CCH) (1976).

²The children's ages are relevant to the deduction of the amount paid for their education in Japan under I.R.C. § 913(f)(1). See *infra* notes 86-88 and accompanying text.

³Henry did not request to be transferred to Tokyo. See *infra* note 59 and accompanying text.

⁴Henry will return to the United States within five years, and will therefore be able to take advantage of I.R.C. § 1034, as amended by § 206 of the Foreign Earned Income Act of 1978, Pub. L. No. 95-615, if he sells his house in the United States. New I.R.C. § 1034(k) suspends the eighteen-month reinvestment period for up to four years for Americans living abroad.

⁵Gulf required the housing accommodations to be of the 'western-type'. . . . 'Western-type' in this context refers to housing with central heating and cooling, separate kitchen, bedroom and living areas, carpeted floors, and certain additional appliances. This contrasted with 'Japanese-style housing' which were usually smaller units with fewer separate rooms, having paper walls, and kitchen and bathroom facilities not as modern as the 'western-type housing'. . . . Generally, such western-style housing costs more than Japanese-style housing, the lessors require a 6- or 12-month advance rental payment plus a similar amount as a deposit in case of damage, and they prefer to enter into lease arrangements with a corporate employer rather than the employee.

McDonald v. Comm'r, 66 T.C. 223, 225, CCH Dec. No. 33,806 at 2773 (1976).

vided to Henry is taxable income.⁶ Prior to the recent passage of section 913,⁷ the tax treatment of Americans living abroad was governed by Internal Revenue Code section 911, and in certain situations by section 119. Americans living abroad could deduct \$15,000 from their foreign-earned income under section 911,⁸ and a few cases held that section 119⁹ entitled taxpayers to exclude the value of meals and lodging provided by an employer. The United States taxes the worldwide income of its citizens.¹⁰ It purports to tax income earned in cash and in kind alike,¹¹ and it does not adjust for differing costs of living within its borders. The question is, then, why an exception should be made for Americans who live and work abroad.

Three issues must be considered before responding to this question. Regardless of Henry's residence in Japan, should the value of the apartment be included in his taxable income? How can part, but not all, of the market value of the apartment be taxed? Is there any reason to treat Henry differently because of his residence in Japan? Discussion of these issues will lead to the principal problem which this note addresses—taxation of certain foreign-earned income in kind—as well as the congressional response thereto.

⁶ [I]ncome is 'the increase or accretion in one's power to satisfy his wants in a given period in so far as that power consists of (a) money itself, or, (b) anything susceptible of valuation in terms of money. More simply stated, the definition of income which the economist offers is this: Income is the *money value of the net accretion to one's economic power between two points of time.*' He emphasized that the definition is in terms of the power to satisfy economic wants rather than the satisfactions themselves.

Good, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 8 (J. Pechman ed. 1977), quoting Haig, *The Concept of Income - Economic and Legal Aspects*, in THE FEDERAL INCOME TAX (R. Haig ed. 1921).

⁷I.R.C. § 913, added by § 203(a) 1978 Foreign Earned Income Act, Pub. L. No. 95-615, effective for taxable years beginning after December 31, 1977. See *infra* notes 69-93 and accompanying text.

⁸See note 69 *infra*. I.R.C. § 911 (as amended, 1976) allows individuals employed by charitable organizations to exclude \$20,000 from their gross incomes. Prior to the 1976 amendment, § 911 provided for a \$20,000 exclusion for foreign-based taxpayers, and a \$25,000 exclusion for employees of charitable institutions.

⁹See *infra* notes 36-50 and accompanying text discussing § 119.

¹⁰"[T]he United States chooses to tax its citizens whether they reside in the United States or overseas. The United States is the only major country that taxes wage and salary income of its nonresident citizens simply because they are citizens." *Taxation of American Working Abroad, Hearings on H.R. 9251 Before the Senate Comm. on Finance*, 95th Cong., 2d Sess. 3 (1978) (statement of Anthony M. Solomon and Donald C. Lubick).

¹¹See Treas. Reg. § 1.61-2(d)(1).

Gross income means all income from whatever source derived, including compensation for services. Sec. 61(a), I.R.C. 1954. It includes income realized in any form, i.e., money, property, or services. If compensation for services is paid in the form of property, the fair market value of the property must be included in income. Sec. 1.61-2(d), Income Tax Regulations. (footnotes omitted).

McDonald v. Comm'r, 66 T.C. 223, 227, CCH Dec. No. 33,806 at 2775(1976), holding that the value of housing provided to the taxpayer by his employer should have been included in the employee's gross income.

Three overriding principles guide United States income taxation: horizontal equity, vertical equity, and neutrality. Horizontal equity means that persons in similar circumstances should be treated similarly.¹² Vertical equity "requires that those with higher incomes [should] pay a higher proportion of their incomes in taxes."¹³ Tax neutrality means that an individual's conduct should not change because of the tax laws.¹⁴ Although certain situations may require that one of these principles be cast aside in favor of more demanding national policies, they provide a basic framework against which the treatment of income may be judged.

EQUITY - WHETHER TO TAX

The question of whether the value of the apartment provided to Henry Taxpayer should be taxed as income demands recognition of "The Tension Between Equity and Practicality."¹⁵ An attempt must be made to establish criteria for determining equality of taxpaying capacity or, if preferred, equality of income-for-tax-purposes. Because taxes must be paid in money, because the amount owed must be readily determinable on the basis of reasonably objective factors, and perhaps for other reasons as well, we generally exclude from the calculus of taxpaying capacity most forms of noncash benefits, such as imputed income and fringe benefits. . . . These exclusions may be bothersome to one who seeks perfect equity in the tax system, but they nonetheless seem quite wise. For the most part, failure to exclude could produce more inequity than it would cure and in any case would create personal hardship.¹⁶

The distinction between income which provides a benefit to the taxpayer and income which is taxed is fundamental to the issue of taxing foreign-earned income in kind. To achieve perfect tax equity, all personal benefits, whether they are obtained in the course of business or not,

¹²Horizontal equity "requires that employment benefits received in kind not be taxed differently from cash benefits." Note, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141, 1142 (1976).

¹³*Id.* at 1143 (footnotes omitted).

¹⁴"The principle of tax neutrality would recommend taxing overseas workers in such a way that the U.S. tax system provides neither an inducement nor a discouragement to U.S. workers in deciding whether to accept employment abroad and to U.S. employers in deciding whether to employ American workers abroad." J. GRAVELLE & D. KIEFER, U.S. TAXATION OF CITIZENS WORKING IN OTHER COUNTRIES: AN ECONOMIC ANALYSIS (Economics Division, Congressional Research Service, Library of Congress, 1978), reprinted in 124 CONG. REC. S7310, 7312 (daily ed. May 11, 1978).

¹⁵Klein, *The Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip - A Conceptual Analysis*, 18 STAN. L. REV. 1099, 1102 (1965-66) (emphasis removed).

¹⁶*Id.*

should be taxed.¹⁷ However, the United States tax base has never included certain advantages, such as the psychological pleasure of particular types of employment, even though a real value is gained.¹⁸ The lack of taxation, whether due to the difficulty of valuation or to a congressional policy (whether active or passive¹⁹), does not itself disprove a benefit to the taxpayer.

TAXATION OF INCOME IN KIND

Type of Item Provided

The fundamental difference between income provided in cash and that provided in kind is that the taxpayer can choose how to use the former, but is usually restricted to using the latter in the form and for the general purpose provided. When income is provided in kind, the characteristic lack of choice will vary in significance according to the nature of the item provided. In deciding whether to tax the value of the item, three questions will illuminate the importance of the restricted use of income in kind. If the employer had given the cash equivalent of the item, would the taxpayer have purchased the type of item provided? Would the taxpayer have purchased an item identical to that provided? Is the item provided worth its cash equivalent to the taxpayer?

If Henry's wife, Wilma, were to win a vacation trip, the answer to the first question would not necessarily be yes, since a vacation trip is not a necessity of life. Because the taxpayer might not have purchased the type of item provided, the form of the item limits the enrichment of the taxpayer to a level below that which would be attained if unrestricted consumption of the cash equivalent were allowed. In the Japanese housing situation, if Gulf did not provide Henry with the apartment, he would have to procure housing for himself; the answer to the first question, then, is yes.

Henry's answer to the second question, however, is not clear. If Henry wanted to live in this kind and quality of housing, he would probably answer the second question affirmatively. However, less expensive Western-style quarters are available in Tokyo, so it is possible that Henry would rent an apartment quite different from that which Gulf procured.

¹⁷Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859, 864-66 (1974).

¹⁸Note, *supra* note 12, at 1147-48.

¹⁹Until recently, Congress did not tax most forms of income in kind specifically, and the courts were left to decide whether such income was taxable under the broad scope of I.R.C. § 61. In the past several years, however, Congress has begun to take a more active stance towards the tax treatment of income in kind and fringe benefits through explicit inclusion or exclusion in the Internal Revenue Code. See generally, Halperin, *supra* note 17; Note, *supra* note 12; 1975 Discussion Draft, *infra* note 37.

The third question, which inquires further into the taxpayer's mind, now becomes relevant. If Wilma does not really want to go on the vacation trip, then its value to her is not its cash equivalent, since she would not pay this amount to enjoy the trip had she been given its market value in cash.²⁰ Henry, on the other hand, probably does consider the apartment worth its equivalent in cash. Since Henry would have had to procure housing had Gulf not provided it for him, and since it is likely that he would have rented a Western-style apartment if he had had the means,²¹ it seems reasonable to conclude that he would value the apartment at its market price.

The answers to these three questions do not conclusively indicate whether to tax the value of the item furnished in kind, but they help decide whether it is fair to tax at least part of the market value of the item provided. They serve as a method of illustrating whether, and to what extent, the income in kind puts the taxpayer in a situation different from that in which the income is in cash.

Source of the Item Provided

If income in kind is received along with cash as compensation, the possibility of disguised wages arises if only the cash is taxed. The principle of tax neutrality²² encourages taxing income received in kind from an employer, since nontaxation could cause overuse of in-kind forms of compensation.²³ If income in kind is not actually taxed, employers can increase taxpayers' total compensation with less expense to themselves, since the tax-free value of the income in kind will not be subject to the

²⁰Thus, the court in *Turner v. Comm'r*, 13 T.C.M. 462 (CCH) (1954), held that only part of the market value of steamship tickets awarded to the petitioner as a prize was includable in the taxpayer's income. In deciding to include less than the fair market value of the tickets in the taxpayer's income, the court noted that the steamship tickets:

were not transferable and not salable and there were other restrictions on their use. . . . Nevertheless, in order to obtain such benefits as they could from winning the tickets, they actually took a cruise accompanied by their two sons, thus obtaining free board, some savings in living expenses, and the pleasure of the trip. It seems proper that a substantial amount should be included in their income for 1948 on account of the winning of the tickets.

Id. at 463.

²¹Western-style apartments are similar to United States housing with respect to modern conveniences, and it appears that most Americans would prefer, and be more comfortable in, such quarters instead of Japanese-style housing. See *supra* note 5.

²²See *supra* note 14 and accompanying text.

²³ If an individual values a form of entertainment at \$2,000, he will obviously prefer \$3,000 in cash which he can spend as he likes. However, if the cash is taxed at a rate of forty or fifty percent, then the untaxed entertainment becomes more valuable. There would thus be a tendency to increase the untaxed component of one's income over the amount that would be expected in an income-tax-free world.

Halperin, *supra* note 17, at 894. See also Note, *supra* note 12, at 1143.

progressive rate structure and will leave the employees' taxable income in a lower tax bracket.²⁴

Before Congress' recent passage of section 913, compensation received in the form of income in kind was not taxed if the expenditure was made primarily for the benefit and convenience of the taxpayer's employer.²⁵ The "convenience of the employer" doctrine was codified in Internal Revenue Code section 119 with respect to meals and lodging. Section 119 was not designed to apply to situations like the Japanese housing case, and although it is still available to residents and nonresidents alike, its value to Americans living abroad has been greatly reduced by section 913.

Disproportionate Amounts

When a large portion of total income is received in kind, consideration must be given to the effect of taxing the entire market value of that portion. Whatever the amount of tax due, it will be paid only out of the disposable cash income. Although a high in-kind-to-cash proportion may trigger the suspicion of disguised wages,²⁶ the same high proportion may place an unduly burdensome tax liability on the employee who is taxed on the value of income in kind and cash alike.²⁷

A disproportionately large amount of income in kind may indicate either a lack of choice or a deliberate choice by the taxpayer: the taxpayer may not be able to choose the item provided or the amount of total compensation used to procure that item, or, on the other hand, the proportion of compensation in kind to that in cash may be the result of a bargain reached by the taxpayer and the employer. If the disproportion impairs the taxpayer's ability to pay the tax owed on total compensation, then the taxpayer would presumably not consider the items provided in kind worth their cash equivalent, and would not have used the cash equivalent to purchase the same items if given a choice.²⁸

²⁴E.g., If Gulf pays Henry \$50,000 cash, subject to 50% rates, and \$20,200 untaxed income in kind, Henry's after-tax income will be \$46,240; Gulf would have to pay Henry nearly \$80,000 cash (taxed at maximum 50% rates for personal service income) to provide him with an equivalent after-tax income.

²⁵See *infra* notes 36-50 and accompanying text discussing I.R.C. § 119.

²⁶See *infra* notes 23-24 and accompanying text.

²⁷In certain extreme cases in extraordinarily high-cost countries, some individuals who receive large non-cash allowances may have a tax liability equal to, or in excess of, their basic cash salaries.

....

For example, we found a typical employee with a wife and two schoolaged children earning \$40,000 could be taxed on the basis of \$131,000 gross income because of housing, education, and other allowances needed in Saudi Arabia.

Taxation of Americans Working Abroad: Hearings on H.R. 9251 Before the Senate Comm. on Finance, 95th Cong., 2d Sess. 9 (1978)(statement of Elmer Staats) [Hereinafter cited as *1978 Senate Hearings*].

²⁸See *supra* note 20 concerning whether the taxpayer thinks the value of the item provided in kind is equal to the item's cash value. See also Halperin. *supra* note 17, at 884.

Analysis with respect to Henry in Japan

The basic question, the appropriate treatment of the value of the housing provided to Henry Taxpayer, may now be approached by comparing the tax treatment suggested by each of the three considerations—the type, source, and proportion of the income in kind—in relation to the facts of the Japanese housing case.

Because the item provided to Henry is housing, an item which Henry would necessarily have to procure for himself, it seems unfair not to tax at least part of the value of the apartment. If the value of the apartment remained wholly tax-free, conspicuous inequity between Henry, who annually receives \$50,000 cash and \$20,200 in kind, and a taxpayer who receives \$50,000 cash and no income in kind, would result. However, it is unclear whether the nature of the item provided demands taxation of its entire market value or simply a portion of it, due to the inability to predict whether Henry would have procured the same apartment if he had been given the choice.

The second consideration, the threat of disguised wages, militates against allowing even a portion of the apartment's market value to go untaxed, since otherwise tax neutrality may be sacrificed. Section 119, although not an answer in itself, also favors taxing the entire market value of the housing provided, since this section would not normally apply to Henry's situation.

If it is unfair to tax Henry on the full market value of the apartment, then the final factor, disproportionality, suggests that partial taxation is the solution. However, there is not such striking disproportionality as would require taxing less than the full value received when Henry's situation is analyzed without regard to his residence in Japan.²⁹ Therefore, it is necessary to consider whether Henry's income in kind should be treated any differently solely because he is in Japan.

RESIDENTS AND NONRESIDENTS COMPARED

The United States is the only major industrial country which taxes on the basis of citizenship rather than residency.³⁰ It has been stated that Congress never seriously considered the possibility of not taxing Americans living abroad.³¹ If residents and nonresidents are in disparate situations for tax purposes, then equal tax treatment of the two groups may result in unfairness to one or both.

²⁹See *supra* note 27.

³⁰See *supra* note 10.

³¹Patton, *United States Individual Income Tax Policy as it Applies to Americans Resident Overseas: Or, If I'm Paying Taxes Equal to 72 Percent of My Gross Income, I Must Be Living in Sweden*, 1975 DUKE L. J. 691, 702.

Two justifications for taxation sharpen the comparison between residents and nonresidents. The idea of economic allegiance has been proposed as one reason citizens acquiesce to the imposition of taxes. Stated simply, this theory asserts that since the government needs money to function properly, each citizen must contribute for the benefit of the whole without regard to the benefits received in return.³² An alternative justification is found in the *quid pro quo* theory, which argues that in exchange for taxes, citizens receive certain benefits and protection from the government.³³ While the former rationale illustrates the similarity of residents and nonresidents (since both groups owe their government economic allegiance), the latter theory focuses on their dissimilarity with respect to the ability to take advantage of goods and services secured by the United States.

The difference between the United States and Japanese costs of living illustrates one distinction between residents and nonresidents. Henry Taxpayer will subjectively consider items to be worth their United States market value; his frame of reference for prices as well as consumables will remain American. When he receives an apartment with a market price of \$20,000 in Japan, he will consider it worth the amount necessary to rent a similar apartment in the United States. Therefore, he will think it unfair to tax the full \$20,000 Japanese market value, since he will not feel \$20,000 richer when Gulf provides him with the apartment.

While Henry is abroad, he will spend his income on items available and useful to him in Japan. Although he may have driven his car to and from work in the United States, he might not use an automobile in Japan because of the availability of public transportation. Americans typically spend seventeen percent of their total incomes on housing;³⁴ yet to obtain what is a modest apartment by American standards, Henry must spend more than twenty-eight percent of his total income—forty percent of his cash income—in Japan. The uses of his income indicate some of the differences between Henry and his American counterpart living in the United States.

³²B. BITTKER, & L. EBB, *TAXATION OF FOREIGN INCOME* 5 (prelim. ed. 1960).

³³But see Patton, *supra* note 31, at 700, who "believes it is inappropriate to attempt to justify the taxation of individual American citizens resident overseas on a *quid pro quo* theory."

That is, services in general are provided to or for residents. Armed forces defend persons and property within the national territory, not just citizens, and generally not including citizens outside the country. Similarly, in the myriad other programs of economic assistance, price supports, law enforcement, and transportation, governments do not spend money to benefit merely their own citizens, and they are not attempting to benefit citizens residing in other countries.

Id. at 699 n.26. Cf. I.R.C. §§ 901-908 (foreign tax credit available to nonresident Americans).

³⁴S. REP. NO. 746, 95th Cong., 2d Sess. 9 (1978).

The cost of living overseas, as well as the different goods and services made available by government spending, disrupts the Internal Revenue Code's assumption that it taxes citizens only to the extent of their "ability to pay."³⁵ Even though this country has never based its authority to tax on the benefits received by its citizens from its use of the tax revenue, perhaps the reason for this is founded on the assumption that all citizens are equally able to take advantage of the benefits provided by the government. This assumption is untrue for Americans living abroad, and the resulting difference between residents and nonresidents should be considered when deciding whether to treat the two groups alike for tax purposes.

INTERNAL REVENUE CODE SECTION 119

Before Congress enacted section 913, the tax treatment of the market value of Henry's apartment was governed by section 119 of the Internal Revenue Code of 1954.³⁶ The all-or-nothing approach taken by section 119 excluded the market value of meals and lodging furnished to the taxpayer if: the housing was provided for the convenience of the employer,³⁷

³⁵"Ability to pay" is used here both in its literal sense—having the cash to pay the tax owed—and in its traditional tax sense of equity—"each individual should be held to help the state in proportion to his ability to help himself." E. SELIGMAN, *THE INCOME TAX* 4 (rev. 2d ed. 1914).

An example illustrates the double meaning of "ability to pay": *A* and *B* each earn \$50,000. *A* wisely invests much of her salary, while *B* spends all of his money on his extravagant lifestyle. *A* and *B* will owe the same amount of tax (equity sense of "ability to pay"), based upon their \$50,000 incomes. However, only *A* has the cash on hand to pay the amount of tax due, since *B* has spent all of his salary and has no money left to pay the amount he owes in taxes (literal sense of "ability to pay").

³⁶ SEC. 119. MEALS OR LODGING FURNISHED FOR THE CONVENIENCE OF THE EMPLOYER.

There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—

(1) in the case of meals, the meals are furnished on the business premises of the employer, or

(2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

In determining whether meals or lodging are furnished for the convenience of the employer, the provisions of an employment contract or of a State statute fixing terms of employment shall not be determinative of whether the meals or lodging are intended as compensation.

³⁷See *supra* note 9 and accompanying text.

The following might be considered in determining what constitutes "convenience of the employer":

The personal use [of facilities, goods, or services provided by the employer] occurs during, immediately before, or immediately after working hours at or near the business premises of the employer and has a proximate relation to work performed by the employee.

....

The benefit accommodates an important requirement of the employer or relieves the employer of significant expense or inconvenience.

accepting the lodging was a condition of employment,³⁸ and the lodging was on the business premises of the employer.³⁹

The typical situation envisaged by section 119 is that where the employee must work in a remote and desolate area where lodging is unavailable,⁴⁰ or where the nature of employment requires that the taxpayer be available twenty-four hours a day.⁴¹

The benefit is reimbursement of a greater than usual item of expense which was incurred by the employee for a purpose normally thought primarily personal but which was incurred because a business requirement of the employer prevented the employee from obtaining the item in the ordinary manner.

The benefit is provided primarily to insure the employee's safety by protecting against significant risk arising from the employment relation.

1975 Discussion Draft issued by the Treasury as Proposed Amendments to Treas. Reg. § 1.61, 40 Fed. Reg. 41118 (1975), *withdrawn* 41 Fed. Reg. 56334 (1976).

³⁸The second and third requirements seem to be indicators of the first, rather than independently useful tests in themselves, and their applications illustrate the definition of the "convenience of the employer" doctrine. The second test is considered met when "the employee is required to accept such lodging . . . in order to enable [the taxpayer] to properly perform the duties of . . . employment." Treas. Reg. § 1.119-1(b) (as amended, 1964). Thus, the condition-of-employment test merely informs whether the lodging does in fact benefit the employer by ensuring or aiding in the fulfillment of business needs. Cf. Note, *Dissection of a Malignancy: The Convenience of the Employer Doctrine*, 44 NOTRE DAME LAW. 1104, 1139 (1969).

³⁹"Business premises," as used in the third test of § 119, has been "construed to mean either (1) living quarters that constitute an integral part of the business property or (2) premises on which the company carries on some of its business activities." *Lindeman v. Comm'r*, 60 T.C. 609, 615 (1973).

This question [whether the lodging is on the business premises of the employer] is largely a factual one requiring a commonsense approach. The statute should not be read literally. . . . [T]he emphasis must be on the place where the employee's duties are to be performed. . . . [T]he statutory language "on the business premises of the employer" infers a functional rather than a spatial unity. . . . [W]e are persuaded that where, as here, (1) the residence was built and owned by the employer, (2) it was designed, in part, to accommodate the business activities of the employer, (3) the employee was required to live in the residence, (4) there were many business activities for the employee to perform after normal working hours in his home because of the extensive nature of the employer's business and the high-ranking status of the employee, (5) the employee did perform business activities in the residence, and (6) the residence served an important business function of the employer, then the residence in question is a part of the business premises of the employer.

Adams v. United States, 214 Ct. Cl. —, 77-2 U.S.T.C. (CCH) ¶ 9613, at 88, 058 (1977). Note that (2) and (6) are factors to be considered when determining whether the lodging was provided for the convenience of the employer, and (3) is simply the condition-of-employment requirement of § 119. The court, it seems, was stretching the broad interpretation already given to the business premises requirement.

⁴⁰ A construction worker is employed at a construction project at a remote job site in Alaska. Due to the inaccessibility of facilities for the employees who are working at the job site to obtain food and lodging and the prevailing weather conditions, the employer is required to furnish meals and lodging to the employee at the camp site in order to carry on the construction project. The employee is required to pay \$40 a week for the meals and lodging. The weekly charge of \$40 is not, as such, part of the compensation includible in the gross income of the employee, and . . . the value of the meals and lodging is excludable from his gross income.

Treas. Reg. § 1.119-1(d) (Example 7) (as amended, 1964).

⁴¹ A Civil Service employee of a State is employed at an institution and is re-

The reason for the [convenience of the employer doctrine] would seem to be grounded in the belief that an injustice would be visited upon an employee . . . [who was] required to pay a tax on the value of meals or lodging furnished . . . by [the] employer, when such meals or lodging were provided more for benefit and convenience of . . . [the] employer than for [the employee].⁴²

When courts sought a solution to the Japanese housing case in section 119, the results were either total inclusion or total exclusion of the market value. The courts focused on the business benefits to the employer and purported to ignore the personal benefits to the taxpayer. Most courts, when ruling on the applicability of section 119 to facts similar to Henry's situation, have disallowed the exclusion for failure to show convenience of the employer.⁴³ These cases, however, illustrated a willingness by the courts to consider the benefit received by the taxpayer, in order to determine whether personal or business aspects dominated the provision of lodging.

quired by his employer to be available for duty at all times. The employer furnishes the employee with meals and lodging at the institution without charge. Under the applicable State statute, his meals and lodging are regarded as part of the employee's compensation. The employee would nevertheless be entitled to exclude the value of such meals and lodging from his gross income.

Treas. Reg. § 1.119-1(d)(Example 5)(as amended 1964). Cf. *Comm'r v. Kowalski*, 430 U.S. 944 (1977), holding that a cash allowance for meals furnished to state police is not excludable under § 119.

⁴²*Dissection of a Malignancy*, *supra* note 38, at 1105.

Prior to the enactment of I.R.C. § 119, judicial exclusion of the value of meals or lodging furnished by the taxpayer's employer was based upon the noncompensatory nature of such items. However, § 119 was designed to eliminate the test of compensation by providing that "the provisions of an employment contract or of a State statute fixing terms of employment shall not be determinative of whether meals or lodging are intended as compensation." See also, *id.* at 1121-22.

Although courts are not now supposed to consider whether income in kind is provided as a part of the employee's compensation, it seems that an analysis which includes reference to the compensatory characteristics of the transaction would prove helpful in the typical Japanese housing case. Where the employer has either computed the employee's average housing costs in the United States, which amount the employee includes in taxable income, or where the employer charges the taxpayer the amount which it would cost to rent a similar apartment in the United States, a test which looks for compensation would regard the excess amount paid by the employer and not charged to the taxpayer as excludable. See *infra* note 45.

⁴³ In *McDonald v. Comm'r*, 66 T.C. 223, CCH Dec. No. 33,806 (1976), the court held that the market value of the apartment provided to the taxpayer was not excludable from the employee's income by virtue of the I.R.C. § 119 meals and lodging exclusion. The court found that none of the three requirements of § 119 were met by the facts of the case.

As to the first of these tests, convenience of the employer, the court held that although convenience may have dictated the form in which the leasehold arrangements were structured, the convenience of Gulf did not require it to subsidize the assignments. While Gulf may have realized some indirect benefit from the arrangements, they were made primarily to meet the needs and for the convenience of its expatriate employees.

Id. at 229, CCH Dec. No. 33,806 at 2777. Cf. *Adams v. United States*, 214 Ct. Cl. —, 77-2 U.S.T.C. (CCH) ¶ 9613 (1977), see *infra* notes 44-50 and accompanying text.

In *Adams v. United States*,⁴⁴ a Japanese housing situation, the court stretched the value of section 119 past its reasonable bounds in order to exclude the market price of housing provided by the taxpayer's employer. The Court of Claims allowed the taxpayer, the president of Sekiyu Oil, a wholly-owned Japanese subsidiary of Mobil, to exclude the market value of the Western-style apartment provided for a nominal rental fee to the taxpayer and his family by Mobil.⁴⁵ The court stressed that the lodging provided was owned by Sekiyu and had been the home of its president for over ten years; moreover, "[t]he den was built specifically for the conduct of business and the kitchen and living room were sufficiently large for either business meetings or receptions."⁴⁶ In addition, great weight was placed upon the lack of a distinction between business and social activities in Japan.⁴⁷

The court in *Adams* focused solely on the business benefit to Sekiyu,

As to the second requirement, that the lodging must be "on the business premises of the employer," the *McDonald* court found that

the occasional entertainment of business guests and the periodic use of the telephone to place or receive business calls not conveniently handled during regular business hours in Tokyo . . . do not constitute the requisite quantum or quality of activities to qualify as the "significant portion" prescribed by both alternative constructions of "on the business premises."

Id. at 231, CCH Dec. No. 33,806 at 2778. See *supra* note 33 for the alternative constructions to which the court refers.

Requirements of the third test, accepting the lodging as a condition of employment, also were not met by the facts of the *McDonald* case, according to the court. With respect to this last element of § 119, the court stated that:

[W]e believe . . . that the condition of employment test requires that the lodging be more integrally related to the various facets of an employee's position; here, we doubt that the proper performance of petitioner's executive and management responsibilities depended on the incidental availability of entertainment and telephone facilities purportedly peculiar to western-style housing.

Id. at 232, CCH Dec. No. 33,806 at 2779.

See also Philip H. Stephens, 35 T.C.M. (CCH) 39 (1976), where the taxpayer conceded that § 119 did not apply to his situation, another Japanese housing case, but argued that he received no "economic benefit" from the income in kind due to inflated prices and undesirable quarters. The court was not swayed, and held the full value of the housing includible under I.R.C. § 61.

⁴⁴214 Ct. Cl. —, 77-2 U.S.T.C. (CCH) ¶ 9613 (1977).

⁴⁵ Mobil first calculated a "U.S. Housing Element" for each American foreign-based employee, based on a survey of the Bureau of Labor Statistics, which reflected the approximate average housing costs in the United States at various family sizes and income levels. Mobil then subtracted from that employee's salary the amount of his particular U.S. Housing Element. If Mobil provided housing to the employee, the employee would include in his gross income for federal tax purposes the U.S. Housing Element amount.

Id. at 88,055.

⁴⁶*Id.*

⁴⁷ The effectiveness of a president of a company in Japan is influenced by the social standing and regard accorded to him by the Japanese business community. "Face" is an almost tangible reality there. If the president of Sekiyu had not resided in a residence equivalent to the type provided the plaintiff, he would have been unofficially downgraded and slighted by the business community and his effectiveness for Sekiyu correspondingly impaired.

and refused to view the personal benefit received by the taxpayer as important. This approach was overgenerous to the taxpayer. The house furnished to Adams was a luxury by Japanese as well as American standards, and exclusion of its value from the taxpayer's gross income created conspicuous tax-free consumption. However, since section 119 did not allow allocation of the housing costs between business and personal benefits conferred, the tendency of the court to err on the side of the taxpayer cannot be condemned.⁴⁸

The *Adams* case was the most liberal application of section 119 to situations similar to that of Henry Taxpayer, and exemplifies the shortcomings of the use of this section in the Japanese housing case. Where, as here, the housing served a substantial benefit to the taxpayer, while only coincidentally furthering the employer's purposes,⁴⁹ the income in kind could not honestly be characterized as provided primarily for the convenience of the employer. Therefore, at least part of the market value of the apartment should have been taxed. The exclusion provided by section 119 was wholly unsuited to deal with Henry's problem in the Japanese housing case, which will now be resolved under the new Internal Revenue Code section 913.⁵⁰

ECONOMIC ISSUES OF TAXATION OF FOREIGN-EARNED INCOME

Prevailing opinion is that it is beneficial to the United States if Henry and other Americans accept temporary employment overseas. Although one congressional study concluded that the link between the balance of trade and Americans working abroad was tenuous,⁵¹ Congress agrees with the business and academic communities that Americans working abroad are an asset to the country's economic health.⁵² It is argued that

⁴⁸"[A] person would have had to pay up to four times his U.S. housing costs to obtain comparable housing in Tokyo." *Adams v. United States*, 214 Ct. Cl. —, 77-2 U.S.T.C. (CCH) ¶ 9613 at 88,057 (1977). "[Q]uarters reasonably equivalent to their American style of living were not available at American prices." *Stephens v. Comm'r*, 35 T.C.M. (CCH) 39, 39-40 (1976). Cases which resemble the Japanese housing situation set out at the beginning of this note stress that the employer obtained the apartment at the fair market price. "There is no evidence that the lodgings occupied by plaintiffs could have been rented for any amount less than paid by Gulf." *McDonald v. Comm'r*, 66 T.C. 223, 234, CCH Dec. 33,806 at 2780 (1976). Thus, to procure similar lodging, the employee would have to pay a similar amount. Of course, the taxpayer could choose to live in a less desirable, and less expensive, apartment than that provided by the employer.

⁴⁹One value to employers of providing lodging to employees is that it helps to attract qualified individuals by facilitating the move overseas.

⁵⁰See *infra* notes 81-84 and accompanying text.

⁵¹Gravelle-Kiefer CRS study, *supra* note 14.

⁵²See 1978 Senate Hearings.

⁵³ Referring once again to my own experience, it is important to emphasize the extent to which U.S. goods tend to follow projects that U.S. firms plan and carry out. For example, in constructing gas-gathering systems or an hydroelectric facility in a foreign country, or a host of other projects, U.S. engineers are more likely to use technology and techniques that require U.S. produced equipment and parts (and this will result in U.S. replacement parts

Americans employed overseas will increase sales of American-made equipment by ordering American instruments for their projects, since "an American is much more likely to specify American products . . . than [is] a French engineer, who is familiar with French products."⁵³

Additionally, while normal tax principles of equity would compare the treatment of resident and nonresident Americans, American companies in Japan must be able to compete with French and British companies in Japan.⁵⁴ These American corporations argue that the burden imposed by taxing their employees as if they were living in the United States, including taxing income in kind, ultimately falls on the employers' shoulders. This is so because American companies want to employ Americans in their overseas operations, but in order to bring American employees overseas, the employers must pay them enough to ensure them a reasonable after-tax income.⁵⁵ Obviously, if the companies endeavor to compensate employees in part with income in kind in the form of a necessary, but extraordinarily expensive, item, their attempts will be undermined by United States taxation of the value of the income in kind; employers may feel forced to provide additional cash compensation to meet the burdens imposed on their employees. A vicious circle can result, with employers reimbursing their employees for additional tax burdens, and the United States taxing the reimbursement and increasing the burden.

Attracting Henry to Japan without undue economic burden to Gulf may require a compromise of both equity and neutrality in the tax treatment of nonresidents. The congressional decision to encourage employ-

being used throughout the life of the project). The engineers and constructors had to become personally known and their work trusted. This leads to future contracts, as well as follow-on work, with additional positive benefits for the U.S. balance of trade.

124 CONG. REC. S7306 (daily ed. May 11, 1978)(statement of George P. Shultz).

⁵³1978 Senate Hearings at 5 (statement of Anthony M. Solomon and Donald C. Lubick). More completely, Solomon and Lubick said:

When overseas Americans are replaced by foreign nationals the U.S. economy loses an employment opportunity and the remittances to the United States which normally accompany such employment. However, from a trade perspective, there can be even more important adverse effects. [As might be expected] . . . an American engineer is . . . likely to specify American products . . . The overseas employment of an American engineer thus creates jobs in the United States. Given the falling share of the United States in world manufactures trade, and our present trade deficit, we need the exports that are created by the employment of overseas Americans.

Id.

⁵⁴124 CONG. REC. S7304 (daily ed. May 11, 1978)(statement of J.M. Sprouse).

⁵⁵ Of the companies surveyed, 77 percent reimburse their American employees for all or part of the additional taxes incurred as a result of living abroad. These companies will have to absorb the potential tax increase, pass the increased costs on to customers, or replace American employees with less costly local or third-country nationals. Companies that do not reimburse their American employees may lose them because of the higher tax burdens.

1978 Senate Hearings at 8 (statement of Elmer Staats). Compare *Old Colony Trust Co. v. Comm.*, 279 U.S. 716 (1929).

ment abroad⁶⁶ overrides the purpose served by neutrality, since that decision carries with it a policy favoring tax laws which spur the desired taxpayer activity. Equity, too, may be of limited importance in resident-nonresident analysis, because the same overseas employment policy requires that less concern be placed upon equal treatment of residents and nonresident similarly situated. However, both equity and neutrality remain useful tools to check the possibilities of obvious injustice through conspicuous tax-free consumption.

THEORIES AND MECHANISMS OF TAXATION OF AMERICANS LIVING ABROAD

The differences in buying power between resident and nonresident Americans, as well as the congressional desire to encourage overseas employment, indicate that Henry's presence in Japan should be of some concern when deciding how to tax the value of the apartment provided by Gulf. Prior to 1978, there was no mechanism in the Internal Revenue Code for taxing only part of the value of Henry's housing; the total market value was either included under the broad definition of income in Internal Revenue Code section 61 or excluded under section 119. Total inclusion, however seems too harsh to accomplish the desire of Congress to promote employment abroad, while section 119 provides an inadequate answer to the Japanese housing case.⁶⁷ Part of the value of Henry's housing should be taxed, since it provides some personal benefit to him and places him in a better position than that of someone earning only \$50,000 in cash. The problem, then, is to find a mechanical method of partial taxation.

Individualized Adjustment Method

When overseas housing and related costs of living are extraordinarily expensive, an adjustment could be made so that the taxpayer would include in taxable income that portion of the market value of the lodging which equals the amount which is normally and reasonably spent on housing and related living expenses in the United States. The excess

⁶⁶ As chairman of the Subcommittee on International Trade, I have recognized the absolute essential role that the Americans living and working abroad play with respect to the American economy.

It would be impossible for American business and American industry to export either services or goods abroad, unless we had Americans working there. If we failed to take action in this field, we would find ourselves in a position in which American companies would have to hire foreign workers.

124 CONG. REC. S7309 (daily ed. May 11, 1978)(statement of Sen. Ribicoff). "The presence of U.S. citizens working abroad encourages the purchase of U.S., instead of foreign, goods and services, and, therefore, the incentive provided by this bill will produce substantial benefits for the U.S. economy." H.R. REP. NO. 1463, 95th Cong., 2d Sess. 7 (1978)(House Ways and Means Committee report on H.R. 13488). See *infra* note 95.

⁶⁷See *supra* notes 37-50 and accompanying text.

housing and living expenses would be excluded from the taxpayer's income. Section 123 of the Internal Revenue Code,⁵⁸ which allows taxpayers whose homes have been destroyed by casualty to exclude insurance receipts for normal costs of living and housing, serves as an example of the individualized adjustment method. This method of taxing Henry Taxpayer's income in kind promotes tax neutrality, since Henry neither gains nor loses by working abroad. It has the additional benefit of avoiding an arbitrary fixed exclusion.

The basic problem with this method of taxation is that it poses a great administrative burden on both the taxpayer and the government. Although the existence of section 123 shows that an individualized method is not administratively impossible, the reasons behind the section 123 individualized exclusion seem much more compelling than those underlying a similar exclusion for excess foreign living and housing costs. Destruction of the taxpayer's home, envisaged by section 123, is an involuntary event, whereas Americans who work abroad can choose whether to accept overseas employment.⁵⁹ The subject matter of section 123 nearly requires the amount of the exclusion to be determined on a case-by-case approach, since the amount of reimbursement by insurance, as well as the amount of excess costs, will vary. On the other hand, excess foreign living and housing costs can be more closely approximated so that the difficulties of substantiation by taxpayers and individualization of the exclusion can be escaped, while arbitrariness is still avoided to a great extent.

Basket of Goods and Services Method

The "basket of goods and services" method⁶⁰ would tax Henry Taxpayer according to the purchasing value of his income. Although similar

⁵⁸ SEC. 123. AMOUNTS RECEIVED UNDER INSURANCE CONTRACTS FOR CERTAIN LIVING EXPENSES.

(a) GENERAL RULE—In the case of an individual whose principal residence is damaged or destroyed by fire, storm, or other casualty, or who is denied access to his principal residence by governmental authorities because of the occurrence or threat of occurrence of such a casualty, gross income does not include amounts received by such individual under an insurance contract which are paid to compensate or reimburse such individual for living expenses incurred for himself and members of his household resulting from the loss of use or occupancy of such residence.

(b) LIMITATION—Subsection (a) shall apply to amounts received by the taxpayer for living expenses incurred during any period only to the extent the amounts received do not exceed the amount by which—

(1) the actual living expenses incurred during such period for himself and members of his household resulting from the loss of use or occupancy of their residence exceeds

(2) the normal living expenses which would have been incurred for himself and members of his household during such period.

⁵⁹Even though Henry did not request a transfer, *supra* note 3, he still had control over the decision to accept the offer of transfer.

⁶⁰Gravelle-Kiefer CRS study, *supra* note 14, at S7316.

to the individualized adjustment method, this system has the advantage of taxing a wider variety of items in the "basket" and providing for a much less individualized (although not so arbitrary) mechanism.

The first and most important step in this approach is to determine what should be included in the "basket"; possibilities include housing, food, household chores, laundry, and transportation. Next, these items are priced in the United States and in the new location abroad, and the difference between the two amounts is computed. Finally, a tax is imposed on the income received at the new location by considering the value of that income as equal to the new foreign income multiplied by the price of the United States basket of goods divided by the price of the foreign basket of goods.⁶¹ The essence of this technique is obtained by using a cost-of-living index to compute the amount excluded from the taxpayer's foreign income to arrive at the equivalent United States income for tax purposes.⁶²

The primary benefit of using the basket of goods and services method is that a balanced picture is obtained; the method does not simply allow a deduction for one extremely expensive item, such as housing, without considering the inexpensive items available abroad. However, by assuming that the " 'basket of goods' purchased abroad will be the same as that purchased in the United States . . . the apparent costs of living abroad [might be increased] if . . . [the basket] includes goods which are in scarce supply or are expensive because they are imported (e.g., Western-style housing in Japan)."⁶³ In addition, the choice must be made whether to compare foreign costs to the most expensive, or to the average, cost of living in the United States.⁶⁴

Base Level of Welfare Method

The zero bracket amount of income⁶⁵ allows persons who receive less than this amount to achieve a base level of welfare without taxation. Persons who receive more than the zero bracket amount may obtain this same "base level of welfare"⁶⁶ with their tax-free income before being

⁶¹See *Eder v. Comm'r, T.C.M. (P-H) ¶ 44,156* (1944), where the court found the value of blocked Colombian pesos by comparing the prices of food and other commodities in the United States and Colombia.

⁶²See *infra* notes 72-80 and accompanying text.

⁶³Gravelle-Kiefer CRS study, *supra* note 14, at S7316.

⁶⁴See *infra* note 75.

I would have preferred the offset to be measured from the highest U.S. living costs, rather than the average U.S. costs. It seems unfair to subsidize Americans who takes [sic] jobs in Tehran or Hong Kong, but not those who go to Boston or New York to take such jobs. The cost of living is identical in all four cities. I see no reason why Uncle Sam [sic] should have to subsidize those who cross an ocean, rather than cross a continent, to find their place of work.

124 CONG. REC. S7310 (daily ed. May 11, 1978).

⁶⁵I.R.C. § 63(d).

⁶⁶Note, *supra* note 12, at 1147.

taxed on the excess. Adjustments could be made to the zero bracket amount so that it would reflect the different overseas costs of necessities such as food and lodging. This would ensure nonresidents a base level of welfare, based upon costs abroad, before being taxed on the excess of their incomes.

This base level of welfare method of taxation would preserve the progressivity of the rate structure by placing the exclusion on the bottom of the structure. It would only consider, in fixing the amount of adjustment, the price differences of life's barest necessities.⁶⁷ The value of Henry Taxpayer's housing in Japan is not equivalent to the most basic type of shelter available in Tokyo, and the exclusion he would enjoy under this method would probably not be great. This method is most likely not generous enough to place Henry in a position similar to that which he enjoyed in the United States, and therefore would not accomplish Congress' intent to encourage Americans to work abroad.

INTERNAL REVENUE CODE SECTION 913

Congress recently enacted a comprehensive method of taxation for nonresident Americans⁶⁸ which replaces the flat exclusion that Internal Revenue Code section 911⁶⁹ previously allowed to Americans living abroad. This new law, Internal Revenue Code section 913, includes five possible deductions from gross income for eligible individuals.⁷⁰ Theoretically, it resembles a combination of the "basket of goods and services" and the "base level of welfare" methods of taxation by adjusting part of the nonresident's income to reflect costs of living (excluding housing and education costs) in the United States.⁷¹ The new section specifically addresses both income in kind and income in cash.

The first deduction allowed by section 913 involves a "qualified cost-of-living differential."⁷² The cost-of-living differential excludes housing and

⁶⁷The base level of welfare method of taxation differs from the basket of goods and services method in two respects: the basket approach involves a wider variety of items, and the exclusion is made off of the top of the taxpayer's income.

⁶⁸I.R.C. § 913 (added by § 203(a) of the Foreign Earned Income Act of 1978, Pub. L. No. 95-615, 92 Stat. 3097 effective for taxable years beginning after December 31, 1977).

⁶⁹I.R.C. § 911 (*as amended*, 1976) allows qualified individuals living abroad to exclude \$15,000 from their gross incomes, or \$20,000 if the taxpayer is employed by a charitable organization abroad. This section is available to taxpayers who do not wish to take advantage of § 913 until January 1, 1979.

Section 911 was amended by § 201 of the Foreign Earned Income Act of 1978, P.L. 95-615, 92 Stat. 3097, to apply only to individuals residing in certain camps.

⁷⁰I.R.C. § 913(a)-(b)

An "eligible individual" is defined as either a United States citizen who is a "bona fide resident of a foreign country . . . for an uninterrupted period which includes an entire taxable year," or a United States resident or citizen who is present in a foreign country for at least 510 days during a period of eighteen consecutive months. *Id.* § 913(a).

⁷¹*See supra* notes 60-64 and accompanying text.

⁷²Section 913(d) on qualified cost-of-living differential reads:

(1) IN GENERAL.—For purposes of this section, the term qualified cost-of-

education expenses, which are separately considered,⁷³ and is based upon the "spendable income of a person paid the salary of a GS-14, step 1 (currently \$32,442) regardless of the taxpayer's actual income."⁷⁴ The differential, to be determined for different localities by the Secretary of the Treasury, will reflect the difference between the cost of living in the foreign place and that in the "metropolitan area in the continental United States (excluding Alaska) having the highest general cost of living."⁷⁵

If indexes compiled by the State Department,⁷⁶ which exclude housing and education costs, are used, approximately \$19,500 will be allowed to Henry Taxpayer as a cost-of-living deduction from his \$50,000 income.⁷⁷ If the cost-of-living indexes from Business International's 1976 Survey

living differential means a reasonable amount . . . prescribed by the Secretary establishing the amount (if any) by which the general cost of living in the foreign place in which the individual's tax home is located exceeds the general cost of living for the metropolitan area in the continental United States (excluding Alaska) having the highest general cost of living. The tables (or other method) so prescribed shall be revised at least once during each calendar year.

(2) SPECIAL RULES.—For purposes of paragraph (1)—

(A) Computation on daily basis.—The differential shall be computed on a daily basis for the period during which the individual's tax home is in a foreign country.

(B) Differential to be based on daily living expenses.—An individual's cost-of-living differential shall be determined by reference to reasonable daily living expenses (excluding housing and schooling expenses).

(C) Basis of comparison.—The differential prescribed for any foreign place—

(i) shall vary depending on the composition of the family (spouse and dependents) residing with the individual . . . and

(ii) Shall reflect the costs of living of a family whose income is equal to the salary . . . [at] the annual rate paid for step 1 of grade GS-14.

I.R.C. § 913(d).

⁷³See *infra* notes 81-88 and accompanying text.

⁷⁴H.R. REP. NO. 1978, 95th Cong., 2d Sess. 14 (1978). (Joint Explanatory Statement of the Comm. of Conference on H.R. 9251) (October 15, 1978). But different family sizes are taken into account. I.R.C. § 913(d)(2)(C)(i).

⁷⁵I.R.C. § 913(d)(1). Prior to the passage of the new section, conflict arose regarding whether the basis for comparing foreign costs to those in the United States should be the highest or the average cost of living in this country. See *supra* note 64.

⁷⁶JOINT COMM. ON TAXATION, 95th Cong., 2d Sess., TAXATION OF AMERICANS WORKING ABROAD, Table 6 at 24-25 (Comm. Print 1978).

⁷⁷The indexes (119 for New York, 165 for Tokyo; *Id.*) first are adjusted so that New York, having the highest cost of living in the United States (except Hawaii and Alaska) equals 100:

$$\frac{119}{100} = \frac{165}{x}$$

$$x = 139 \quad (x \text{ equals the adjusted index for Tokyo})$$

The taxpayer's income (excluding housing and education expenses) is then multiplied by the differential for Tokyo, and the income is then subtracted from this product to equal the amount excludable as a qualified cost-of-living expense.

$$\begin{array}{r} \$50,000 \text{ (income minus housing and education expenses)} \\ \times 1.39 \text{ (cost of living differential)} \\ \hline \$69,500 \end{array}$$

of Executive Living Costs⁷⁸ are used, Henry would deduct only \$8,000.⁷⁹ The disparity between the State Department index and the Business International index illustrates the problem of choosing which goods and services to use as a basis of comparison between the United States and the foreign locality when computing the differential.⁸⁰

The second deduction allowed by section 913 is for "qualified housing expenses."⁸¹ The computations required to determine the amount of the

\$69,500
 —50,000

\$19,500 (amount excludable by Henry)

⁷⁸*Taxation of Americans Working Abroad*, Table 6, *supra* note 76.

⁷⁹The indexes (119 for New York, but only 138 for Tokyo; *id.*) first are adjusted so that New York equals 100:

$$\frac{119}{100} = \frac{138}{x}$$

x = 116 (qualified housing differential)

The differential is then multiplied by the taxpayer's income (excluding housing and education expenses); this amount, minus the income, equals the qualified housing expense.

\$50,000 (income less housing and education expenses)
 x1.16 (cost of living differential)
 \$58,000

\$58,000
 —50,000

\$ 8,000 (amount excludable by Henry)

⁸⁰See *supra* note 63 and accompanying text.

⁸¹Section 913 reads:

(e) QUALIFIED HOUSING EXPENSES.—

(1) IN GENERAL.—For purposes of this section, the term "qualified housing expenses" means the excess of—

- (A) the individual's housing expenses, over
- (B) the individual's base housing amount,

(2) HOUSING EXPENSES.—

(A) IN GENERAL.—For purposes of paragraph (1), the term "housing expenses" means the reasonable expenses paid or incurred during the taxable year by or on behalf of the individual for housing for the individual (and, if they reside with him, for his spouse and dependents) in a foreign country. Such term—

(i) except as provided in clause (ii), includes expenses attributable to the housing (such as utilities and insurance), and

(ii) does not include interest and taxes of the kind deductible under section 163 or 164 or any amount allowable as a deduction under section 216(a).

(B) PORTION WHICH IS LAVISH OR EXTRAVAGANT NOT ALLOWED.—For purposes of subparagraph (A), housing expenses shall not be treated as reasonable to the extent such expenses are lavish or extravagant under the circumstances.

(3) BASE HOUSING AMOUNT.—For the purposes of paragraph (1)—

(A) In general.—The term "base housing amount" means 20 percent of the excess of—

(i) the individual's earned income (reduced by the deductions properly allocable to or chargeable against such earned income (other than the deduction allowed by this section)), over (ii) the sum of—

deduction are basically twofold: first, the "base housing amount" is calculated by taking twenty percent⁸² of the individual's earned income minus (1) allocable deductions other than those in section 913⁸³ and (2) the sum of the individual's actual housing expenses, the qualified cost-of-living differential, school expenses, home leave travel expenses, and the hardship area deduction.⁸⁴ The amount which Henry may deduct from his gross income as a qualified housing expense equals his actual housing expense minus his base housing amount.⁸⁵

In addition to the cost-of-living and housing adjustments, section 913

(I) the housing expenses taken into account under paragraph (1)(A) of this subsection,

(II) the qualified cost-of-living differential,

(III) the qualified school expenses,

(IV) the qualified home leave travel expenses, and

(V) the qualified hardship area deduction.

(B) **BASE HOUSING AMOUNT TO BE ZERO IN CERTAIN CASES.**—If, because of adverse living conditions, the individual maintains a household for his spouse and dependents at a foreign place other than his tax home which is in addition to the household he maintains at his tax home, and if his tax home is in a hardship area as defined . . . the base housing amount for the household maintained at his tax home shall be zero.

(4) **PERIODS TAKEN INTO ACCOUNT.**—

(A) **IN GENERAL.**—The expenses taken into account under this subsection shall be only those which are attributable to housing during periods for which—

(i) the individual's tax home is in a foreign country, and

(ii) except as provided in subsection (i)(1)(B)(iii), the value of the individual's housing is not excluded under section 119.

(B) **DETERMINATION OF BASE HOUSING AMOUNT.**—The base housing amount shall be determined for the periods referred to in subparagraph subsection (i)(1)(B)(iii).

(5) **ONLY ONE HOUSE PER PERIOD.**—If, but for this paragraph, housing expenses for any individual would be taken into account under paragraph (2) of subsection (b) with respect to more than one abode for any period, only housing expense with respect to that abode which bears the closest relationship to the individual's tax home shall be taken into account under such paragraph (2) for such period.

⁸² This 20 percent figure is based on the premise that a typical American living overseas would spend approximately one-sixth (16½ percent) of his income on housing if he lived in the United States. The mathematical equivalent of 16½ percent of the taxpayer's earned income minus his education and home-leave allowance and his *excess* housing costs is 20 percent of the taxpayer's earned income minus the allowable deductions for education and home-leave and minus the *total* cost of the employee's housing.

TAXATION OF AMERICANS WORKING ABROAD, *supra* note 76, at 10.

⁸³ These allocable deductions are business expenses. Cf. I.R.C. § 1348(b)(2) (last sentence).

⁸⁴ I.R.C. § 913(e)(3)(A).

⁸⁵ Base Housing Amount

\$20,000	(actual housing expenses)
200	(school expenses)
<u>+13,750</u>	
\$33,950	

also provides for a qualified schooling expense deduction.⁸⁶ Under this section, Henry may deduct a reasonable amount "incurred by or on behalf of . . . [himself] for the education of each dependent . . . at the elementary or secondary level."⁸⁷ The amount to be deducted may include tuition, books, and transportation to a local "United States-type school," and the additional costs of room and board if there is not an adequate school in the taxpayer's locality. This deduction seems sensible according to the "benefits received" rationale for taxation, since education is free in the United States.⁸⁸

A "home leave travel expense" deduction allows one round trip per

\$70,200	(Henry's total income)
<u>-33,950</u>	(sum of housing, education, cost of living, above)
\$36,250	
<u>× 0.20</u>	
\$ 7,250	(base housing amount)

Qualified Housing Expense

\$20,000	(actual housing expenses)
<u>-7,250</u>	(base housing amount)
\$12,750	(qualified housing expense)

⁸⁶ (f) QUALIFIED SCHOOLING EXPENSES—

(1) IN GENERAL.—For purposes of this section, the term "qualified schooling expenses" means the reasonable schooling expenses paid or incurred by or on behalf of the individual during the taxable year for the education of each dependent of the individual at the elementary or secondary level. For purposes of the preceding sentence, the elementary or secondary level means education which is the equivalent of education from the kindergarten through the 12th grade in a United States-type school.

(2) EXPENSES INCLUDED.—For purposes of paragraph (1), the term "schooling expenses" means the cost of tuition, fees, books, and local transportation and of other expenses required by the school. Except as provided in paragraph (3), such term does not include expenses of room and board or expenses of transportation other than local transportation.

(3) ROOM, BOARD, AND TRAVEL ALLOWED IN CERTAIN CASES.—If an adequate United States-type school is not available within a reasonable commuting distance of the individual's tax home, the expenses of room and board of the dependent and the expenses of the transportation of the dependent each school year between such tax home and the location of the school shall be treated as schooling expenses.

(4) DETERMINATION OF REASONABLE EXPENSES.—If—

(A) there is an adequate United States-type school available within a reasonable commuting distance of the individual's tax home, and

(B) the dependent attends a school other than the school referred to in subparagraph (A), then the amount taken into account under paragraph (2) shall not exceed the aggregate amount which would be charged for the period by the school referred to in subparagraph (A).

(5) PERIOD TAKEN INTO ACCOUNT.—An amount shall be taken into account as a qualified schooling expense only if it is attributable to education for a period during which the individual's tax home is in a foreign country.

⁸⁷*Id.*

⁸⁸However, it is the state property taxes, rather than the federal revenue, which are principally used to provide funding for public schools. See *supra* note 34 and accompanying text.

twelve-month period that the taxpayer is abroad for each member of the taxpayer's family.⁸⁹ The amount excludable is limited to the price of coach airplane fare.⁹⁰

The "hardship area" deduction⁹¹ involves designation by the Secretary of State as to what areas qualify, and presumably will not include Tokyo.

Henry's taxable income under section 913 is approximately \$43,560—only sixty-two percent of his total income of \$70,200.⁹² Since he receives a cash salary of \$50,000, the concern that he will be unable to pay the additional tax burden attributable to the income in kind⁹³ is now of no merit. Under section 913, the cost of the apartment charged to Henry's income will be \$7,350, approximately its rental cost in the United States. Henry therefore will have no reason to feel burdened by taxation of this amount since it represents the value which Henry will place upon the apartment.

⁸⁹ (g) QUALIFIED HOME LEAVE TRAVEL EXPENSES.—

(1) IN GENERAL.—For purposes of this section, the term "qualified home leave travel expenses" means the reasonable amounts paid or incurred by or on behalf of an individual for the transportation of such individual, his spouse, and each dependent from the location of the individual's tax home outside the United States to—

(A) the individual's present (or, if none, most recent) principal residence in the United States, or

(B) if subparagraph (A) does not apply to the individual, the nearest port of entry in the continental United States (excluding Alaska) and return.

(2) ONE ROUND TRIP PER 12-MONTH PERIOD ABROAD.—Amounts may be taken into account under paragraph (4) or subsection (b) only with respect to one round trip per person for each continuous period of 12 months for which the individual's tax home is in a foreign country.

⁹⁰ § 913(j)(2)

LIMITATION TO COACH OR ECONOMY FARE.—The amount taken into account under this section for any transportation by air shall not exceed the lowest coach or economy rate at the time of such transportation charged by a commercial airline for such transportation during the calendar month in which such transportation is furnished. If there is no such coach or economy rate or if the individual is required to use first-class transportation because of a physical impairment, the preceding sentence shall be applied by substituting "first-class" for "coach or economy".

⁹¹ (h) QUALIFIED HARDSHIP AREA DEDUCTION.—

(1) IN GENERAL.—For purposes of this section, the term "qualified hardship area deduction" means an amount computed on a daily basis at an annual rate of \$5,000 for days during which the individual's tax home is in a hardship area.

(2) HARDSHIP AREA DEFINED.—For purposes of this section, the term "hardship area" means any foreign place designated by the Secretary of State as a hardship post where extraordinarily difficult living conditions, notable unhealthful conditions, or excessive physical hardship exist and for which a post differential of 15 percent or more—

(A) is provided under section 5925 of title 5, United States Code, or

(B) would be so provided if officers and employees of the Government of the United States were present at that place.

⁹² If Henry elects to have § 119 rather than § 913 apply, his taxable income (including the value of his housing) will be \$52,200 (using \$750 deduction of § 151), or seventy-four (74) percent of his total income.

⁹³ See *supra* notes 26-28 and accompanying text.

If section 913 deserves any criticism, it is for its overgenerosity to nonresident taxpayers. It is difficult to justify the separate adjustment for housing expenses, since the high cost of housing may be offset by very low prices of other goods and services. Obviously, Congress intended the special housing deduction to eliminate the issue of whether income in kind in the form of housing should be taxed at the full market value. However, if the cost-of-living differential were computed to include housing costs, it would theoretically calculate the United States equivalent of the value of Henry's total income.

In addition, section 913 does not provide for upward adjustment of the nonresident's income where the cost of living overseas is lower than that in New York. An American living in London, where the cost of living is below that in New York,⁹⁴ would be able to take advantage of the qualified housing deduction even though the actual housing expenses, coupled with the lower cost of living, might place this foreign-based taxpayer in the same position as an American residing in New York City.⁹⁵ Perhaps the cost-of-living tables and regulations will cure some of this exaggerated generosity.

CONCLUSION

The new tax treatment of Americans living abroad will encourage taxpayers to accept overseas employment. It may also, however, raise cries of outrage in the United States for similar cost-of-living adjustments, particularly for Hawaii and Alaska.⁹⁶ Section 913 is not neutral, but it abandons neutrality in favor of what Congress hopes will benefit residents and nonresidents alike—a sounder economy in the United States as well as a fairer tax policy towards its citizens.

CAROLE SILVER ADLER

⁹⁴The State Department's cost of living tables show Tokyo with a cost of living of 165, New York with 119, and London with 102. SEE TAXATION OF AMERICANS WORKING ABROAD, Table 6, *supra* note 76.

⁹⁵In a house bill, H.R. 13488, which proposed treatment similar to § 913 for Americans living abroad, an amendment to § 911 was proposed which would have made the flat exclusion applicable only to Americans residing in "a qualified foreign country . . . (that is, countries other than Canada or those in Western Europe)." H.R. REP. NO. 1463, 95th Cong., 2d Sess. 9 (1978). This type of limitation on the foreign locality could have been used in the new § 913 as a condition to taxpayer qualification as an "eligible individual," since many of the excluded countries (Western Europe and Canada) have costs of living below that of New York. SEE TAXATION OF AMERICANS WORKING ABROAD, Table 6, *supra* note 76.

⁹⁶TAXATION OF AMERICANS WORKING ABROAD, Table 6, *supra* note 76.